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IN THE
Supreme Court of the United States
OCTOBER TERM, 1997

THOMAS E. BENNETT, JOAN A. BENNETT,
THEODORE BLACK and MARILYN BLACK,
Petitioners,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Second Circuit

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REPLY MEMORANDUM FOR THE PETITIONERS

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1. In *United States v. Boyle*, 469 U.S. 241 (1985), this Court held, in unambiguous terms, that good faith reliance on a tax adviser establishes the reasonableness of the taxpayer's conduct so as to reject the Commissioner's assertion of the negligence penalty. In so holding, the Court necessarily assumed that the accountant or attorney upon whom the taxpayer relies was competent to render tax advice and that the adviser would not be burdened by a conflict of interest. However, the Court did not condition its holding upon a showing by the taxpayer that the adviser was expert in the particular technology underlying the taxpayer's investment.

The decision below squarely conflicts with the standard established by this Court in *Boyle*. In upholding the imposition of the negligence penalty in this case, the court of appeals ratified the conclusion of the Tax Court that

petitioners' reliance on the opinions of a reputable law firm and an officer of a major bank and its tax department was not reasonable because these advisers were not expert in the plastics recycling technology that underlay the particular investment. But this ruling cannot be reconciled with either *Boyle* or *Chamberlain v. Commissioner*, 66 F.3d 729 (5th Cir. 1995), and *Durrett v. Commissioner*, 71 F.3d 515 (5th Cir. 1996). In those two latter cases, the Fifth Circuit flatly held that under the teaching of *Boyle*, the taxpayers' reliance upon a lawyer for advice with respect to a complex straddle transaction involving forward securities contracts relieved them of the negligence penalty. While the government seeks to distinguish *Chamberlain* and *Durrett* on the purported ground that the taxpayers there relied "on advisors who were more knowledgeable of such transactions" (Br. in Opp., p. 13), that is assuredly not the case. Rather, the Tax Court in *Chamberlain* and *Durrett* premised its imposition of the negligence penalty on the ground that the advisers were not qualified because they "never understood how the program worked." (67 T.C.M. 2992, 2994; 67 T.C.M. 2735, 2742).[1] Hence, the government's attempts to distinguish *Chamberlain* and *Durrett* are unavailing. Indeed, if any doubt remains that the Fifth Circuit rejects the imposition of the negligence penalty against a taxpayer who relies upon a competent tax adviser, we call the Court's attention to the Fifth Circuit's recent decision in *Streber v. Commissioner*, No. 96-60443, decided April 15, 1998. There, the Fifth Circuit, in conformity with *Chamberlain* and *Durrett*, once again rejected the Tax Court's imposition of the negligence penalty against taxpayers who relied upon the advice of an attorney with respect to the reporting of a particular transaction on their tax return.[2] In these cir-

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[1] In so holding, the Tax Court concluded in *Durret* and *Chamberlain* that the taxpayers "did not rely on competent independent parties . . . ." (67 T.C.M. 2742, 2994).

[2] For the convenience of the Court, we have reproduced the Fifth Circuit's opinion in *Streber v. Commissioner* in Appendix A, *infra*, pp. 1a-27a.

cumstances, "having done no less than reasonable prudence demands, the [taxpayers] should not be held negligent in their treatment of the joint venture income." Appendix A, *infra*, p. 7a. Accord: *Betson v. Commissioner*, 802 F.2d 365, 372 (9th Cir. 1986) (Kennedy, J.) (reliance upon *Boyle* for the proposition that "the taxpayer relied in good faith on the substantive advice of his accountant"). The decision below therefore conflicts with *Chamberlain* and *Durrett*.

2. Nor is the government on any sounder ground in asserting (Br. in Opp., pp. 13-14) that "Petitioners acknowledged that they were *more* knowledgeable than their advisors on the critical factual issues and that they were aware of the limitations of their advisor's expertise." (emphasis in original). The sole basis for the government's characterization is its citation of two excerpts of testimony by petitioners (Br. in Opp., pp. 7-8). But the excerpts of testimony cited by the government establish no such admissions by petitioners. When petitioner Bennett acknowledged that "retrospectively it would have been a smarter thing to [go to Hyannis] to examine the plastics recycling machinery" (J.A. 236; J.A. 238), he was simply stating that if such a trip would have served to establish his due diligence and absolve him of the negligence penalty, he regretted, in hindsight, not having done so. Plainly, Bennett was not "admitting" that he was more knowledgeable than the evaluators, the lawyer who rendered the opinion, the Bankers Trust officer, and the Bankers Trust organization, or that a trip to Hyannis by him would have made any difference. In sum, petitioners' hindsight expressions of regret regarding the purported wisdom of their making a visit to the factory that manufactured the machinery in question did not constitute admissions that they could have evaluated the machinery any more accurately than their advisers.[3]

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[3] Petitioner Black made the point even more forcefully. As Black stated, "I think I've tried to describe to you the degree that I studied the evaluation of the machines. I relied on others. *In hindsight*, not very brilliant on my part, but I don't know whether the

3. Furthermore, the government errs in asserting (Br. in Opp., p. 12) that the attorney upon whom petitioners relied did not validate the price of the recyclers. At the conclusion of his comprehensive written opinion, the attorney unambiguously stated that "it is our opinion that if questions are raised by the Internal Revenue Service with respect to [the numerous tax issues], they will be resolved in favor of the partnership." (J.A. 629). While the attorney earlier properly acknowledged in his opinion (J.A. 585) that the Internal Revenue Service was not bound by the written evaluation report appended to the offering memorandum (J.A. 638, 648), the attorney was required by the standards set forth in Treasury Circular 230, § 10.33(a)(1)(iv) to "examine the terms and conditions upon which the property was (or is to be purchased) to determine whether the stated purchase price reasonably may be considered to be its fair market value." See Appendix B, *infra*, pp. 28a-29a.[4] Hence, the attorney's positive opinion necessarily examined and agreed with the premises underlying the professional evaluation report that the price paid for the machinery and the rent paid by the partnership were "fair and reasonable" (J.A. 648).[5]

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outcome would have been much different." (J.A. 336) (emphasis supplied). To the same effect is Black's further statement that the analyses and advice he received from Taggart, Gallagher, and Bankers Trust were ultimately rejected eleven years later by the Tax Court in the *Provizer* case. As Black testified, "I felt I was getting enough input and *in hindsight* I was wrong." (J.A. 347) (emphasis supplied).

[4] For the convenience of the Court, we have reproduced in Appendix B, *infra*, pp. 28a-35a, the pertinent provisions of Treasury Circular 230, which prescribe the professional standards for the issuance of tax opinions such as the attorney's opinion in this case.

[5] There is likewise no merit to the government's argument (Br. in Opp. 10) that petitioners were negligent because the offering memorandum was "replete with warnings of business and tax risks . . . ." There is, however, nothing unusual about such disclosures in offering memoranda. Rather, they are a standard part

Nor is the government correct in asserting that petitioners were negligent because of "the extraordinary tax benefits" available to investors in the transaction. The fact that the amount of the tax benefits exceeded petitioners' cash investment was hardly a cause for concern. It is beyond question that petitioners were entitled to claim their aliquot share of the partnership's cost basis in the machinery. See Section 1012 of the Internal Revenue Code. However, the partnership's cost basis in the machinery was equal to the cash expended, plus the nonrecourse debt incurred in the acquisition of the machinery. This conclusion is a consequence of the bedrock federal income tax principles established by this Court's decisions in *Crane v. Commissioner*, 331 U.S. 1 (1947); and *Commissioner v. Tufts*, 461 U.S. 300 (1983).

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of such documents and attorneys' opinions in order that the offerors comply with the securities laws, which have been in place for more than sixty years. The inclusion of such warnings and risk factors in the offering memorandum was to inform prospective investors of both the positive and the negative aspects of the transaction in order that they could make an informed judgment as contemplated by the securities laws. See *SEC v. Capital Gains Research Bureau*, 375 U.S. 180, 186 (1963).

Moreover, the attorney's discussion of the tax risks in his opinion was fully in conformity with the professional standards set forth in Treasury Circular 230, *supra*. Section 10.33(a)(4) of Treasury Circular 230 provides that "Where possible, the practitioner must provide an opinion whether it is more likely than not that an investor will prevail on the merits of each material tax issue presented by the offering memorandum which involves a *reasonable possibility of a challenge by the Internal Revenue Service*." (emphasis supplied.) See Appendix B, *infra*, p. 29a. Hence, in rendering such an opinion, a responsible practitioner such as Taggart was required to discuss the possibility of a challenge by the Internal Revenue Service. Accordingly, any reliance by the government and the decision below upon the discussion of tax risks in the offering memorandum and in the attorney's opinion betrays an entirely unrealistic view of the professional standards underlying the preparation of such offering materials and legal opinions.

4. In sum, the decision below departs from the standard established by this Court in *Boyle* and thereby casts doubt upon the heretofore well established proposition that a taxpayer cannot be subject to the negligence penalty for taking a reporting position on his tax return with respect to which he has sought advice from a competent tax professional who is not burdened by any conflict of interest. This Court should therefore grant review and reaffirm the teaching of *Boyle* that, "To require the taxpayer to challenge the attorney, to seek a 'second opinion,' or to try to monitor counsel on the provisions of the Code himself would nullify the very purpose of seeking the advice of a presumed expert in the first place." (469 U.S. at 251).[6]

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[6] The government denies that the decision below turns on the fact that the petitioners' advisers were not expert in the particular technology underlying their investment. Rather, the government argues (Br. in Opp., p. 10, n.5) that the factual nature of the question presented is illustrated by the fact that the Tax Court has concluded that "some of the investors" in the transaction at issue were not negligent. In support of this assertion, the government cites *Zidanich v. Commissioner*, 70 T.C.M. 367 (1995). The government's submission, however, leads precisely to the opposite conclusion. As the list of decisions set forth in Appendix C, *infra*, pp. 36a-38a demonstrates, the *Zidanich* ruling was the only case that the Tax Court Special Trial Judge ruled in favor of two taxpayers with respect to the negligence penalty. Apart from *Zidanich*, the Tax Court Special Trial Judge has thus far uniformly imposed the negligence penalty in 54 plastics recycling cases on the ground that the advisers were not expert in plastics recycling technology. Indeed, in one of these cases (*Merino*), the Tax Court Special Trial Judge found the taxpayer negligent even though he was a professor of engineering and a plastics and oil pricing expert who had personally inspected the machinery and its operation and closely questioned his colleagues at Celanese Corporation about the manufacturer's reputation, the machinery, and other similar machinery. See Appendix C, *infra*, p. 37a.

CONCLUSION

For the reasons stated above and in the petition for a writ of certiorari, the petition for a writ of certiorari should be granted.

Respectfully submitted,

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